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ABSTRACT

The role of endowments in academic finances of higher education is examined. Two effects of the decline of endowment funding, their failure to keep pace with inflation and loss of income for innovative programs, are cited. The historical role of endowments in institutional finances is reviewed. Present concepts of endowment management are discussed, including the "total return" investment approach and management objectives in the areas of spending policy, portfolio diversification, and endowment growth. The possible effects of ethical issues on endowment funds is illustrated by the South African-related investments. Decisions to divest all South African stocks cause a number of problems for institutions, not only possible loss of revenue due to divestiture costs and lack of sound investment possibilities but also possible loss of potential contributions from business. A current attitude among college and university investors is that their presence in South Africa can contribute to changing current conditions. It is concluded that the decline of endowments' contributions to general institutional revenues is part of the general financial problem in academe, and that current policy seems to dictate a more balanced management approach that would protect endowment principal and seek profit by diversifying the portfolio into several different types of financial markets. (PHR)

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COLLEGE AND UNIVERSITY ENDOWMENTS—OR, SINGING THE INFLATION BLUES

By Carol Herrnstadt Shulman

"Endowment [at the wealthiest colleges and universities] would have to rise an additional 33 percent to maintain 1973 purchasing power in 1978. This devastating loss in purchasing power is being felt throughout the college and university world and helps explain some of the more recent fiscal problems being experienced by many endowed institutions, especially those that rely more heavily on their endowment to meet current operating expenses." (Dresner 1978, p. 43)

The nation's heavily endowed educational institutions are losing ground to inflation—despite funds totaling more than $10.5 billion. In 1977-1978 alone, endowment funds of 144 colleges and universities, representing more than one-half of all educational endowment wealth, experienced a real decline in purchasing power of about 5 percent—more than $5.1 million.

Given the magnitude of this financial loss, endowment issues are an appropriate concern of the entire academic community. But the problems involved in managing endowment funds are unfamiliar to most campus officials. This *Currents* provides an introduction to the role of endowments in academic finances. It describes present concepts of endowment management, and it looks at new investment strategies for coping with the burden of inflation. Finally, it discusses how ethical issues may affect endowment funds, as exemplified by the controversial area of South African-related investments.

Endowment's Role in Institutional Finances

Historically, endowment earnings have been an important source of college and university income. In 1900, these earnings made up 25 percent of educational costs, but by the late 1950's, this figure had declined to 5 percent (Cary and Bright 1969).

Despite this percentage decline, endowment income is still a significant source of revenue for independent and public institutions. Endowment income at the nation's most heavily endowed private institutions now supply an average of only 12 percent of current fund revenues. But, when current fund revenues average $70.7 million, the endowment contribution is important—$4,484,000. In the public sector, the endowment income's contribution is smaller—2.6 percent—but since current fund revenues average $211 million, endowment's contribution is an impressive $5,486,000 (Dresner 1978).

The importance of endowment revenues is particularly evident at the institutional level. Yale University, for example, suffered serious losses in its endowment income from 1968-1978 because of reverses on the stock market. In 1968, endowment income paid for almost 25 percent of Yale's expenses. Ten years later, its contribution, including capital gains as well as dividends and interest, was only 13 percent ($28.3 million) of a $218 million budget ("Yale Buys . . ." 1978).

Endowment revenues comprise a portion of an institution's general revenue funds that supports the total array of institutional activities. Given this important role, the decline in endowment funds can have both obvious and subtle effects on institutional life. *First*, endowment funds are expected to serve all generations of students equally—to provide a continuing level of quality education. Therefore, endowment funds need to keep abreast of inflation, which they do not currently do (Williamson and Sanger 1979, Dresner 1978). Colleges and universities have found a short-term solution to this decline in revenue that is so effective that the Higher Education Price Index has risen less than the Consumer Price Index for 1975-1978 (Halstead 1978). Institutions have resisted the inflationary spiral to a limited degree by holding down increases in their personnel costs. For example, the difference between faculty salary increases and the increase in the CPI saved institutions $105 million in 1978 alone (Halstead 1978). Williamson and Sanger (1979) suggest that this stringency over faculty salaries is an effect in part of reduced endowment income, which will have to be made up from endowment revenue at some future date.

Second, reduced endowment income is likely to affect academic life in ways that are difficult to measure. Ideally, colleges and universities should be able to use endowment income to support innovative programs and practices free from external influences; further, institutions in the independent sector might use endowment funds to narrow the tuition gap between themselves and public institutions. These purposes of endowment income may not be well served given the current state of endowment fund finances.

Managing Endowment Income

Over the past ten years, analysts have intensely scrutinized endowment fund management. As a consequence, a revolution in endowment fund management has occurred: historic objectives have been reevaluated and placed in a modern context, legal requirements have been altered, new investment strategies are being explored and employed, and adaptations continue to be made.

For most of this century, endowment fund managers invested their funds in fixed-return holdings, such as bonds and mortgages. However, they continued to follow the spending practices of an earlier period, when endowment income came from land holdings whose value increased with flation. That is, endowment income was considered to be the revenue derived from the principal, less any expenses (Ennis and Williamson 1976). This policy is now inappropriate because of the influence of inflation.

During the 1960's this practice became increasingly counterproductive because the rapidly expanding higher education community experienced high inflation, and fixed-return investments did not meet colleges' and universities' needs. At the same time, the stock market held great promise for investors in growth stocks who sought their returns in capital gains, i.e.

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appreciation, rather than dividends (Ennis and Williamson 1976)

Cary and Bright (1969) stepped into this breach between traditional investment policies and a promising, but generally untried strategy—investment in growth stocks—to analyze the legal obligations of endowment managers and to introduce the potential benefits of a new approach to institutional investments and of a spending policy that would enable fund managers to take advantage of a rising stock market

Introducing "total return." Cary and Bright's (1969) suggested strategy, was new to the higher education community but not to the business world. Over a thirty-year period, investors had shifted their interests from investments that provided fixed dividends and interest to investments with long-term growth potential In so doing, they had redefined the concept of "income" to include realized appreciation as well as dividends and interest

This approach to investments is known as "total return" Total return is an investment strategy in which investments are made with regard to the long-term growth potential of the holding Investments are thus likely to be made in common stock rather than in fixed-income instruments Returns from these investments are identified as dividends, interest, and realized appreciation Returns are then allocated between spendable funds and the endowment fund to build up the principal This method has three important advantages (1) over the past century "the annual return (including gains as well as dividends) on unselected common stocks as a group has been double that of high-quality fixed income securities" (Cary and Bright 1969, p 31), (2) it provides a hedge against inflation since the investment appreciates in value, and (3) it allows greater flexibility in spending endowment returns (Cary and Bright 1969)

Higher education financial managers of course were aware of the benefits of this approach, but they feared that the terms and conditions of their endowment gifts and the laws regulating the activities of charitable trusts would effectively prevent them from following this course

Cary and Bright (1969) argued that current laws, court decisions, and the terms of most endowment gifts would permit colleges and universities to follow total return strategy, particularly if "reasonable guidelines are developed to govern [the expenditure of income]" (p 40) Although no firm guidelines then existed, either in law or court decisions, these attorneys suggested that the standard of prudence, i.e. "practical wisdom,' or the 'provident or cautious use of resources' " will be the determining criteria for evaluating endowment management (Cary and Bright 1969, p 41) Under this standard, two practices should be followed (1) addition to the principal of enough realized appreciation to compensate for inflation and "to bring about a steady flow of real spendable income", and (2) "appropriate provision for probable losses before appreciation [is] spent" (Ennis and Williamson 1976, p 9)

Adopting Total Return—Some institutions followed Cary and Bright's recommendations rather promptly, but others were reluctant to do so unless there were clear-cut legal guidelines The real changeover to the total return strategy in the higher education community therefore occurred in the early 1970's, after the development of the Uniform Management of Institutional Funds Act, approved by the National Conference of Commissioners on Uniform State Laws in 1972, and adopted in many states (Ennis and Williamson 1976) This law clearly permitted endowment managers to follow a total return strategy By 1974, a majority of colleges and universities in a survey of 383 institutions reported that they accepted the legality of spending capital gains from endowment funds, where not specifically prohibited For one-fourth of these institutions, this opinion represented a shift in viewpoint since 1971 (Cary and Bright 1974)

Over the long haul, the total-return policy holds significant promise for flexibility and improved returns in endowment management But the recent performance of the stock market suggests that the total return strategy should not be limited to common stock investments because the stock market has been highly volatile

These fluctuations had been largely unanticipated when more flexible and heavier investment in growth stocks was advocated Historically, the stock market has yielded good returns, but over the past twenty-five years the structure of the market has changed, more than half of the trading is now done by institutional investors rather than individual investors, and this situation creates a less stable market, that is, when a smaller number of stockholders (i e institutional investors) hold larger blocks of stocks, their decisions to buy or sell may create large fluctuations in the marketplace (Malkiel and Firstenberg 1976) Consequently, institutions that began to invest large portions of their endowment funds in common stock during the late 1960's and early 1970's experienced some financial shocks

> Most of the institutions shifting to the new rule anticipated a problem in stabilizing their spending, but few were prepared to deal adequately with the very wide fluctuations shown by the stock market in the past few years (*Funds for the Future* 1975, p 121)

Current Management Objectives—Endowment fund managers are most concerned with the problems posed by the continuing high rate of inflation That is, inflation erodes the real value of the endowment principal, at the same time, it escalates the price of institutional operations so that endowment's contribution to institutional revenue becomes increasingly important The dilemma endowment managers face is how to preserve the principal so that future needs can be met while at the same time providing adequate resources for current programs Harvard's goals statement presents the problem clearly

> The objective of the Harvard Fund is to invest in such a manner as to create a stream of investment returns which treats equitably, in inflation adjusted dollars, all generations of students and the public as beneficiaries of the various Harvard programs, and does so at a level of risk which is prudent (*Funds for the Future* 1975, p 156, citing Harvard University)

To resolve these issues, endowment managers need to develop policies in three major areas (1) spending policy, (2) portfolio diversification, and (3) endowment grants

Spending Policy—With the greater flexibility that total return provides, endowment managers and trustees also have more responsibility for determining the spending of endowment funds They must decide how much of the endowment's earnings—appreciation, dividends, and interest—to spend on a yearly basis * In light of inflation, they also need to consider current and future financial contributions from the endowment and yearly fluctuations in returns from the endowment that can affect the level of spending Further, they must decide on policy six to twelve months before the fiscal year begins, since colleges and universities need that much time to develop an annual budget

To assure themselves of a reasonably stable level of yearly income from endowment, managers have developed spending rules Most commonly, institutions decide "to spend a small fraction of the endowment each year, without regard to whether the dollars spent are dividends, interest, or capital gains" (p 21) This is a generic spending rule, from which several rules follow. It has several advantages (1) the fraction may be changed without altering the investment mix of the portfolio, (2) spending grows at the same rate as the endowment, so that managers can control the level of spending by changing the portfolio mix or by altering the spending rate, and (3) spending will never bankrupt the endowment

This rule, however, obviously permits wide fluctuations in yearly income as returns on investments reflect changes in the economy To offset this problem, institutions may adopt variations on this spending rule For example, many colleges and

*The following discussion is based on Ennis and Williamson 1976

universities spend a fraction that is the "moving average of market values of the endowment fund" (p. 22), so that spending does not abruptly change when the value of the endowment changes on a short-term basis

Portfolio Diversification—Since the adoption of a more aggressive investment posture, endowment managers have learned the necessity of portfolio diversification. As used here, this concept refers not only to having shares in a range of publicly-held companies, but to investing funds in different types of financial markets to protect the endowment against unforeseen changes in any one market, and to alleviate the impact of poor investment decisions (Adams 1975). One approach to diversification may be to have a portfolio composed of (1) *Common Stocks*. This investment promises the greatest profit over time, but a portfolio composed solely of common stocks involves too much risk and may not produce enough income for those endowment funds that do not permit the spending of capital gains, (2) *Fixed Income Securities*. This investment approach entails little or no risk, but its yield does not provide a hedge against inflation, and (3) *Short-term Investments*. These can meet needs for immediately available funds to be profitably reinvested (Williamson in *Funds for the Future* 1975).

But this tripartite approach may not protect endowments when the financial markets are at a low point. Recognizing this problem, colleges and universities are looking to ventures outside the traditional money markets. For heavily endowed institutions, real estate investments may be a rewarding proposition. Yale University, for example, has turned over about 10 percent of its endowment funds to real estate ventures. In one investment, Yale has purchased a half-interest in the Corning Glass Building, a prime Manhattan location, for a little under $15 million ("Yale Buys ..." 1978).

Other institutions are launching programs into the venture capital market. In terms of endowment wealth, 80 percent of the ten wealthiest institutions and 57 percent of the thirty most heavily endowed institutions are using a small percentage of their endowments to become involved in this concept (Lewis 1979). The venture capital concept involves "the investment of equity capital in nonpublic securities of small (to $100 million sales) high-growth companies that offer significant opportunities for capital appreciation. This definition is not intended to encompass investments in real estate, natural resources, or credit and lending functions" (Adams and Poitras 1978, p. 2). In addition, institutions interested in venture capital investments may seek out mature companies that are low-growth and have substantial debt, with the expectation that if the company cancels its debt it will experience new growth and return a profit to the investor (Lewis 1978).

Endowment Growth—In this period of high inflation, returns on investments will apparently not meet all endowment needs. There is a trend toward larger endowments that are built by new gifts to the endowment (Dresner 1978). Indeed, building endowments to offset the problems of inflation may be considered part of endowment management. Campaign fund drives can be explicit on the need to enlarge the endowment to offset inflation. Dartmouth's campaign literature to win $80 million for its endowment explains this situation:

> Under normal circumstances [endowment] provides a stable flow of dollars which are directly translated into fine programs. ... When operating costs soar more rapidly than endowment appreciates, or when the endowment's percentage contribution to cash flow declines, those same programs are in jeopardy (*The Campaign for* ... n.d., p. 26).

Socially-Aware Investment

Academic endowment managers and trustees cannot ignore one of the most volatile campus issues of the 1970's—the university's social responsibilities as an investor. This issue has been simmering for some time. Since the 1960's, universities have been called upon to take public positions on a wide range of social problems, such as the War in Vietnam or civil rights. The current pressures to consider the university's investment responsibilities are a logical extension of the earlier debates on the university's role in society.

It has also become evident that the university will face increasing pressures as an investor to take positions on social issues. Corporate responsibility has emerged as an important public issue; and special interest groups are likely to continue their efforts to effect change through shareholder resolutions (Simon et al. 1972).

In this context, model guidelines developed by Yale faculty members who participated in a year-long seminar on university investment responsibilities have served as a prototype for several institutions, and indicate the direction that may be taken on this issue. The guidelines stipulate that

> Maximum economic return will be the exclusive criterion for selection and retention of the university's endowment securities, except in cases covered by [the paragraphs below] relating to the disposition of securities in certain circumstances (Simon et al. 1972, p. 173).

They also prohibit the purchase or retention of securities for the purpose of having the university take a position on the corporation's activities.

The exceptions referred to above involve cases in which a finding of "grave social injury" has been made. Such injury is defined as

> the injurious impact which the activities of a company are found to have on consumers, employees, or other persons, particularly including activities which violate, or frustrate the enforcement of, rules of domestic or international law intended to protect individuals against deprivation of health, safety, or basic freedoms (Simon et al. 1972, p. 171).

Given a finding of grave social injury, the university will not exercise its shareholder rights to vote upon resolutions correcting the injury, but will instead dispose of its holdings, if, (1) it is "unlikely that, within a reasonable period of time, the exercise of shareholder rights" will effectively modify the grave aspect of the social injury, or (2) or changes in company activities will weaken the economic return on the investment so that the university should sell its holdings under the criterion of maximum economic return, or (3) the securities were to be sold as part of routine portfolio management before corrective proposals initiated by the university could be completed (Simon et al. 1972).

The Example of South Africa—When colleges and universities are called upon to divest themselves of South African related stocks, the twin issues of fiduciary and social responsibility come into play.

On the financial side, institutions with substantial endowments have to consider the impact that divestiture of South African related stocks would have on their funds in terms of sound investment possibilities that are lost and in transfer costs. For example, Stanford University, the nation's second most heavily endowed institution (Dresner 1978), studied its portfolio and concluded that such divestiture would produce serious financial problems for the university. The heavy costs involved raise the question of whether the University would violate its fiduciary responsibilities if it were to pursue a policy of divestment of companies doing business in South Africa.

Such divestiture would be expensive: costs for divestment and exclusion (due to limited selection of new stock) would total about $1.4 million. But the greater cost would likely be in the decreased value of the endowment that results from more limited and less profitable investment opportunities and the narrower diversity of the portfolio. A final consideration must be the effect on potential donations from businesses and other sources. If Stanford were to maintain a blacklist of companies in which it would not invest, it might also lose charitable contributions from these companies, which have given donations in the past ("Exclusion of ..." 1977).

The costs of divestiture may be much smaller for less heavily endowed institutions and some colleges are moving toward the sale of all South African-related stock. For example, in 1977 Hampshire College decided to sell all of its common stock, about $200,000 worth, until it could develop appropri-

ate policy guidelines. The decision followed student protests over about $39,000 in South African-related holdings (Liff 1978).

But the full force of the problem of investment in South African-related corporations becomes apparent when the question of social responsibility is raised. While it is generally agreed that apartheid is a reprehensive system and needs to be eliminated, there is a wide gap between strategy advocated by protesting groups and the course followed by most colleges and universities. Student and other groups contend:

> the presence of American corporations in South Africa gives moral legitimacy to the white minority regime, and that it creates a vested American interest in the status quo ... withdrawal of investment and moratorium on loans would deal a severe psychological blow to the morale of the white regime ... and would constrict the historically high rate of economic growth many analysts consider crucial to its stability (Liff 1978, p. 3).

Most institutional investors contend instead that their presence in South Africa can contribute to changing the system. They argue that if they improve their employment practices for blacks, and increase their economic opportunities, they can upgrade the condition of black workers in South Africa while providing an example of responsible corporate behavior. Further, they believe that withdrawal will not alter the system of apartheid.

College and university investors generally side with this position, with one major proviso: many will divest themselves of stocks in corporations that do not adopt and implement the "Sullivan Principles." Institutions may decide that adherence to these principles is an efficient standard for determining whether or not modification of "grave social injury" is occurring and certain stocks should be sold. These principles call on American corporations doing business in South Africa to agree to take specific steps to improve working conditions for blacks, including complete desegregation of all areas in the workplace, develop training programs to place blacks and other nonwhites in higher level positions, and improve the quality of employees' lives outside the workplace in such areas as housing and schools ("Six Principles ... 1970).

Conclusion

Most higher education forecasts argue that inflation, reduced student enrollments, and soaring cost will produce economic hardships for colleges and universities. The decline of endowment's contribution to general revenues is also part of this problem.

In the past ten years, collegiate endowment management has seen rapid change—from a conservative passive approach to investments that yielded steady but insufficient returns, to an aggressive strategy that involved great risks and sometimes produced financial reversals. Current policy seems to dictate a more balanced management approach that would protect endowment principal and seek profit by diversifying the portfolio into several different types of financial markets. It is too early to predict how successful this practice will be in stemming the decline of the endowment's contribution. Any upward trend would be most welcome.

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